



## Prudential Standard 3PS 110

### Capital Adequacy

#### **Objective and key requirements of this Prudential Standard**

This Prudential Standard requires a Level 3 Head to ensure that the Level 3 group maintains sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to their APRA beneficiaries is not adversely impacted by risks emanating from the group, including its non-APRA-regulated institutions.

The ultimate responsibility for the prudent management of capital of a Level 3 group rests with the Board of its Level 3 Head. The Board of the Level 3 Head must ensure that the Level 3 group maintains an appropriate level and quality of capital commensurate with the type, amount and concentration of risks to which the group's APRA beneficiaries are exposed.

The key requirements of this Prudential Standard are that the Level 3 Head must:

- ensure that the Level 3 group has an Internal Capital Adequacy Assessment Process;
- ensure that the Level 3 group maintains required levels of eligible capital;
- inform APRA of any adverse change in the Level 3 group's actual or anticipated capital adequacy; and
- obtain APRA's approval for any planned capital reductions.

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## Authority

1. This Prudential Standard is made under:
  - (a) section 11AF of the *Banking Act 1959* (Banking Act);
  - (b) section 32 of the *Insurance Act 1973* (Insurance Act); and
  - (c) section 230A of the *Life Insurance Act 1995* (Life Insurance Act).

## Application

2. APRA may, at its discretion, apply the Level 3 prudential framework to a group which it considers to perform material activities across more than one APRA-regulated industry and/or in one or more non-APRA-regulated industries. To this effect, APRA may determine by notice in writing that an:
  - (a) authorised deposit-taking institution (**ADI**) or authorised non-operating holding company (NOHC) under the Banking Act;
  - (b) authorised **general insurer** (GI) or authorised NOHC under the Insurance Act; or
  - (c) authorised **life company** (LI) or registered NOHC under the Life Insurance Act,is the 'Level 3 Head' of a **Level 3 group**.
3. This Prudential Standard applies to each Level 3 Head in respect of which APRA makes a determination under paragraph 2. A Level 3 Head must ensure that the requirements in this Prudential Standard are met by the Level 3 group, where applicable.
4. This Prudential Standard commences on 1 January 2014.

## Interpretation

5. Terms that are defined in *Prudential Standard 3PS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.

## Interaction with other Prudential Standards

6. The requirements in this Prudential Standard are in addition to the obligations imposed on **APRA-regulated institutions** by other Prudential Standards.

## Responsibility for capital management

7. Capital is the cornerstone of a Level 3 group's financial strength. It supports the group's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enables the group to continue to operate in a sound and viable manner while the problems are addressed or resolved.

8. Capital management must be an integral part of a Level 3 group's risk management, by aligning its risk appetite and risk profile with its capacity to absorb losses.
9. The Board of directors (Board) of a Level 3 group must ensure that the group maintains a level and quality of capital such that the ability of its APRA-regulated institutions to meet their obligations to **APRA beneficiaries** is not adversely impacted by risks emanating from the group, including its **non-APRA-regulated institutions**. In doing so, the Board must have regard to any prospective changes in the group's risk profile and its capital.
10. Where a Level 3 group is part of a **wider conglomerate group**, the Level 3 group may be exposed to risks, including reputational and contagion risk, through its association with other members of the wider conglomerate group. Problems arising in other members in the wider conglomerate group may compromise the financial and operational position of the Level 3 group. The Board of a Level 3 Head, in determining the capital adequacy of the Level 3 group, must have regard to:
  - (a) risks posed to the Level 3 group by other members in the wider conglomerate group, including the impact on the ability of the Level 3 group to raise funding and additional capital should the need arise;
  - (b) obligations, both direct and indirect, arising from the Level 3 group's association with other members of the wider conglomerate group that could give rise to a call on the capital of the Level 3 group; and
  - (c) the ability to transfer capital (including situations where the wider conglomerate group is under financial or other forms of stress) from the wider conglomerate group to recapitalise the Level 3 group or other members of the wider conglomerate group. This includes consideration of:
    - (i) the integration of business operations within the wider conglomerate group;
    - (ii) the importance of members of the wider conglomerate group to that group;
    - (iii) the impact of cross-border jurisdictional issues;
    - (iv) differences in legislative and regulatory requirements that may apply to members of the wider conglomerate group; and
    - (v) the impact of taxation and other factors on the ability to realise investments in, or transfer surplus capital from, members of the wider conglomerate group.
11. Where a Level 3 Head is a NOHC authorised under the Banking Act or the Insurance Act or registered under the Life Insurance Act and the NOHC is not part of an **ADI Level 2 group** or a **general insurance Level 2 group** ('Level 3 NOHC'), it must limit its activities to those outlined in Attachment A to this Prudential Standard.

12. Where a Level 3 group contains an ADI or an ADI Level 2 group, APRA may, by notice in writing to the Level 3 Head, determine a limit upon the amount of funding to the ADI or ADI Level 2 group from a **Level 3 institution** or from a group of Level 3 institutions in the Level 3 group.

### **Internal Capital Adequacy Assessment Process**

13. A Level 3 Head must ensure that the Level 3 group has an Internal Capital Adequacy Assessment Process (ICAAP) that must:
  - (a) be adequately documented, with the documentation made available to APRA on request; and
  - (b) be approved by the Board of the Level 3 Head initially, and when significant changes are made to the ICAAP.
14. A Level 3 group's ICAAP must be appropriate to the group's size, business mix and complexity of its operations and group structure.
15. The ICAAP must include at a minimum:
  - (a) adequate policies, procedures, systems, controls and personnel to identify, measure, monitor and manage the risks to APRA beneficiaries arising from the Level 3 group's activities on a continuous basis, and the capital held against such risks;
  - (b) a strategy for ensuring adequate capital is maintained over time, including specific capital targets set out in the context of the Level 3 group's risk profile, the Board of the Level 3 Head's risk appetite and regulatory capital requirements. This includes plans for how target levels of capital are to be met and the means available for sourcing additional capital where required;
  - (c) actions and procedures for monitoring the Level 3 group's compliance with its regulatory capital requirements and capital targets. This includes the setting of triggers to alert management to, and specified actions to avert and rectify, potential breaches of these requirements;
  - (d) a process for assessing and addressing the capital shortfall in non-APRA-regulated institutions in the Level 3 group and, where applicable, its Level 3 NOHC in accordance with paragraphs 55 to 59 inclusive;
  - (e) stress testing and scenario analysis relating to potential risk exposures and available capital resources, including in relation to the assessment of the capital shortfall in non-APRA-regulated institutions in the Level 3 group and, where applicable, its Level 3 NOHC;
  - (f) processes for reporting on the ICAAP and its outcomes to the Board of the Level 3 Head and **senior management** of the Level 3 group, and for ensuring that the ICAAP is taken into account in making business decisions;

- (g) policies to address the capital impact of material risks not covered by explicit regulatory capital requirements; and
  - (h) an ICAAP summary statement as defined in paragraph 16.
16. The 'ICAAP summary statement' is a high-level document that describes and summarises the capital assessment and management processes of the Level 3 group. It must outline at a minimum the aspects of the ICAAP listed in paragraphs 15(a) to 15(g) inclusive. The ICAAP summary statement must also include:
- (a) a statement of the objectives of the ICAAP, the expected level of financial soundness associated with the capital targets and the time horizon over which the ICAAP applies;
  - (b) a description of the key assumptions and methodologies utilised by the Level 3 group in its ICAAP, including stress testing and scenario analysis;
  - (c) triggers for reviewing the ICAAP in light of changes to business operations, regulatory, economic and financial market conditions, group structure and other factors affecting the Level 3 group's risk profile and capital resources;
  - (d) a summary of the Level 3 group's policy for reviewing its ICAAP, including who is responsible for the review, details of the frequency and scope of the review, and mechanisms for reporting on the review and its outcomes to the Board of the Level 3 Head and senior management of the group;
  - (e) a description of the basis of measurement of capital used in the ICAAP, and an explanation of the differences where this basis differs from that used for Level 3 eligible capital (**Level 3 EC**); and
  - (f) references to supporting documentation and analysis as relevant.
17. A Level 3 Head must ensure that the Level 3 group's ICAAP is subject to regular and robust review by appropriately qualified persons who are operationally independent of the conduct of capital management. The frequency and scope of the review must be appropriate to the Level 3 group, having regard to its size, business mix, complexity of its operations and group structure, and the nature and extent of any changes that have occurred or are likely to occur in its business profile or its risk appetite. A review must be conducted at least every three years. The review must be sufficient to reach a view on whether the ICAAP is adequate and effective.
18. A Level 3 Head must, on an annual basis, provide a report on the implementation of the Level 3 group's ICAAP to APRA (ICAAP report). A copy of the ICAAP report must be provided to APRA no later than three months from the date on which the report has been prepared.
19. The ICAAP report must include:

- (a) detailed information on current and three-year projected capital levels relative to minimum regulatory capital requirements and target levels;
  - (b) detailed information on the actual outcomes of applying the ICAAP over the period, relative to the planned outcomes in the previous ICAAP report (including analysis of the Level 3 group's actual capital position relative to minimum regulatory capital requirements and capital targets and actual-versus-planned capital management actions);
  - (c) a description of material changes to the ICAAP since the previous ICAAP report;
  - (d) detail and outcomes of stress testing and scenario analysis used in undertaking the ICAAP;
  - (e) a breakdown of capital usage over the planning horizon, as relevant, by material:
    - (i) business activity;
    - (ii) group members;
    - (iii) geographic spread of exposures; and
    - (iv) risk types;
  - (f) an assessment of the capital shortfall in non-APRA-regulated institutions in the Level 3 group and, where applicable, its Level 3 NOHC and the unrestricted surplus capital available to address this shortfall in accordance with paragraphs 55 to 59 inclusive;
  - (g) an assessment of anticipated changes in the Level 3 group's risk profile or capital management processes over the planning horizon;
  - (h) details of any review of the ICAAP since the previous ICAAP report, including any recommendations for change and how those recommendations have been, or are being, addressed; and
  - (i) references to supporting documentation and analysis as relevant.
20. The ICAAP report submitted to APRA by the Level 3 Head must be accompanied by a declaration approved by the Board and signed by the Chief Executive Officer (CEO) of the Level 3 Head stating whether:
- (a) capital management has been undertaken by the Level 3 group in accordance with the ICAAP over the period and, if not, a description of, and explanation for, deviations;
  - (b) the Level 3 group has assessed the capital targets contained in its ICAAP to be adequate given the size, business mix, complexity of its operations, location of operations of Level 3 institutions in the group and complexity of the group structure; and

- (c) the information included in the ICAAP report is accurate in all material respects.

### **Level 3 Prudential Capital Requirement**

21. This Prudential Standard establishes a risk-based approach to measuring the capital adequacy of a Level 3 group. The required level of capital for **Level 3** regulatory purposes is referred to as the Level 3 Prudential Capital Requirement (Level 3 PCR).<sup>1</sup> The Level 3 PCR is intended to take account of the full range of risks to which APRA beneficiaries of the group are exposed.
22. A Level 3 Head must ensure that the Level 3 group, at all times, maintains Level 3 EC in excess of the Level 3 PCR.
23. The ‘Level 3 PCR’ is equal to the sum of the Level 3 prescribed capital amount (as defined in paragraph 24) and any Level 3 supervisory adjustment (as defined in paragraph 25).
24. The ‘Level 3 prescribed capital amount’ is determined by summing the required capital for each of the following ‘industry blocks’ (refer to paragraphs 26 and 27 on the allocation of Level 3 institutions<sup>2</sup> in the Level 3 group to the industry blocks):
- (a) ADI block;
  - (b) GI block;
  - (c) LI block;
  - (d) Super block;
  - (e) FM block; and
  - (f) OA block.
25. APRA may, in writing to a Level 3 Head, determine a ‘Level 3 supervisory adjustment’ to be included in the Level 3 PCR of the Level 3 group and may, in writing to a Level 3 Head, vary the Level 3 group’s Level 3 supervisory adjustment at any time.

### **Allocation of Level 3 institutions to industry blocks**

26. A Level 3 Head must, for the purposes of determining the Level 3 PCR, allocate all Level 3 institutions in the Level 3 group to the industry blocks listed in paragraph 24 as follows, having regard to the requirements set out in paragraph 27:

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<sup>1</sup> The Level 3 PCR is defined in paragraph 23.

<sup>2</sup> Certain institutions may have their activities split between the Super, FM and OA blocks; refer to paragraph 27.



- (a) 'ADI block' – the ADI Level 2 group<sup>3</sup>, or, where there is no ADI Level 2 group, the ADIs<sup>4</sup> and equivalent overseas deposit-taking institutions;
  - (b) 'GI block' – the general insurance Level 2 group<sup>5</sup>, or, where there is no general insurance Level 2 group, the general insurers and equivalent overseas general insurers;
  - (c) 'LI block' – the life companies (including friendly societies) and equivalent overseas institutions engaged in life insurance business;
  - (d) 'Super block' – the **RSE licensees**;
  - (e) 'FM block' – all institutions conducting funds management activities<sup>6</sup> not captured in the ADI, LI or Super blocks. The FM block includes the non-superannuation funds management activities of **dual licensed entities**; and
  - (f) 'OA block' – all other Level 3 institutions in the Level 3 group. The OA block includes the Level 3 Head where it is a Level 3 NOHC.
27. For the purposes of allocating Level 3 institutions in the Level 3 group to the industry blocks in accordance with paragraph 26:
- (a) a **funds management institution** that conducts non-funds management activities must allocate these activities to the OA block; and
  - (b) a dual licensed entity must allocate its **RSEs** to the Super block, its other funds management activities to the FM block and its non-funds management activities to the OA block.
28. Funds management activities may be undertaken by a range of institutions that are allocated to different industry blocks in a Level 3 group. For the purposes of this Prudential Standard, 'funds management activities' are defined as:
- (a) for institutions in the ADI, LI and FM blocks, the provision of investment and related services for the administration or management of investors' funds, excluding custodial services and advisory business; and
  - (b) for institutions in the Super block, the management of the total balances of RSEs.

Institutions in the GI and OA blocks are not regarded as conducting funds management activities.

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<sup>3</sup> Non-consolidated subsidiaries of the Level 2 group are excluded from this block and must be assigned to the other industry blocks, as appropriate.

<sup>4</sup> Or the **ELEs** where applicable.

<sup>5</sup> Refer to footnote 3.

<sup>6</sup> Funds management activities are defined in paragraph 28.

### Required capital for industry blocks

29. The method for calculating required capital for each industry block is outlined in paragraphs 30 to 54 inclusive.
30. Where items are deducted from Level 3 EC in accordance with *Prudential Standard 3PS 111 Capital Adequacy: Measurement of Capital* (3PS 111), to avoid duplication these items must be excluded from the determination of required capital for the relevant industry block(s).

### Required capital – ADI block

31. Subject to paragraph 32, required capital for the ADI block is determined as follows:

$$RC_{ADI\ block} = \sum_i \max(CET1\ PCR_i \times RWA_i, \{Tier\ 1\ PCR_i \times RWA_i\} - AT1_i, \{Total\ Capital\ PCR_i \times RWA_i\} - AT1_i - Tier\ 2_i)$$

where:

- (a)  $i$  is an ADI Level 2 group or, where there is no ADI Level 2 group, an ADI<sup>7</sup> or equivalent overseas deposit-taking institution;
- (b)  $RWA$  is the total risk-weighted assets determined in accordance with *Prudential Standard APS 110 Capital Adequacy* (APS 110), excluding any risk-weighted intra-group transactions and exposures (ITEs) (determined in accordance with paragraphs 41 to 48 inclusive);
- (c)  $CET1\ PCR$  is the Common Equity Tier 1 PCR determined in accordance with APS 110;
- (d)  $Tier\ 1\ PCR$  is the Tier 1 PCR determined in accordance with APS 110;
- (e)  $Total\ Capital\ PCR$  is the Total Capital PCR determined in accordance with APS 110;
- (f)  $AT1$  is the Additional Tier 1 capital determined in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111); and
- (g)  $Tier\ 2$  is the Tier 2 capital determined in accordance with APS 111.
32. Where equivalent overseas deposit-taking institutions are included in the ADI block on a standalone basis, the Level 3 group must include the minimum capital required by the host jurisdiction in a consistent manner in the calculation referred to in paragraph 31. APRA may direct a Level 3 Head to instead apply a proxy based on the requirements in APS 110.

<sup>7</sup> Or the ELE where applicable.

*Required capital – GI block*

33. Subject to paragraph 34, required capital for the GI block is determined as follows:

$$RC_{GI\ block} = \sum_i \max(CET1\ PCA_i, Tier\ 1\ PCA_i - AT1_i, PCR_i - AT1_i - Tier\ 2_i)$$

where:

- (a) *i* is a general insurance Level 2 group or, where there is no general insurance Level 2 group, a GI or equivalent overseas general insurer;
  - (b) *CET1 PCA* is 60 per cent, or a greater percentage as determined by APRA in accordance with *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112), of the prescribed capital amount determined in accordance with *Prudential Standard GPS 110 Capital Adequacy* (GPS 110), excluding any ITEs (determined in accordance with paragraphs 41 to 48 inclusive);
  - (c) *Tier 1 PCA* is 80 per cent, or a greater percentage as determined by APRA in accordance with GPS 112, of the prescribed capital amount determined in accordance with GPS 110, excluding any ITEs (determined in accordance with paragraphs 41 to 48 inclusive);
  - (d) *PCR* is the PCR determined in accordance with GPS 110, excluding any ITEs (determined in accordance with paragraphs 41 to 48 inclusive);
  - (e) *AT1* is the Additional Tier 1 capital determined in accordance with GPS 112; and
  - (f) *Tier 2* is the Tier 2 capital determined in accordance with GPS 112.
34. Where equivalent overseas general insurers are included in the GI block on a standalone basis, the Level 3 group must include the minimum capital required in the host jurisdiction in a consistent manner in the calculation referred to in paragraph 33. APRA may direct a Level 3 Head to instead apply a proxy based on the requirements in GPS 110.

*Required capital – LI block*

35. Subject to paragraph 36, required capital for the LI block is determined as follows:

$$RC_{LI\ block} = \sum_i \max(CET1\ PCA_i, Tier\ 1\ PCA_i - AT1_i, PCR_i - AT1_i - Tier\ 2_i)$$

where:

- (a) *i* is a life company or equivalent overseas institution engaged in life insurance business;

- (b) *CET1 PCA* is 60 per cent, or a greater percentage as determined by APRA in accordance with *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112), of the prescribed capital amount determined in accordance with *Prudential Standard LPS 110 Capital Adequacy* (LPS 110), excluding any ITEs (determined in accordance with paragraphs 41 to 48 inclusive);
  - (c) *Tier 1 PCA* is 80 per cent, or a greater percentage as determined by APRA in accordance with LPS 112, of the prescribed capital amount determined in accordance with LPS 110, excluding any ITEs (determined in accordance with paragraphs 41 to 48 inclusive);
  - (d) *PCR* is the PCR determined in accordance with LPS 110, excluding any ITEs (determined in accordance with paragraphs 41 to 48 inclusive);
  - (e) *AT1* is the Additional Tier 1 capital determined in accordance with LPS 112; and
  - (f) *Tier 2* is the Tier 2 capital determined in accordance with LPS 112.
36. Where equivalent overseas life companies are included in the LI block on a standalone basis, the Level 3 group must include the minimum capital required in the host jurisdiction in a consistent manner in the calculation referred to in paragraph 35. APRA may direct a Level 3 Head to instead apply a proxy based on the requirements in LPS 110.

#### *Required capital – Super block*

37. Subject to paragraph 38, required capital for the Super block is determined as follows:

$$RC_{Super\ block} = \sum_i ORFR_i$$

where:

- (a) *i* is an RSE licensee; and
  - (b) *ORFR* is the operational risk financial requirement (ORFR) target amount as determined in accordance with *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114), adjusted for funds other than external funds in accordance with paragraphs 43 to 45 inclusive, and adjusted for shareholder funds determined in accordance with paragraph 42(c).
38. For the purposes of calculating required capital for the Super block, where applicable *ORFR* refers to the ORFR target amount determined by APRA in accordance with SPS 114.

#### *Required capital – FM block*

39. Required capital for the FM block is determined as follows:

$$RC_{FM\ block} = \max \left( ICA_{FM}, \sum_i Other\ reg\ requirements_i \right)$$

where:

- (a)  $ICA_{FM}$  is the Level 3 group's internal capital allocation for the risks of the activities conducted in the FM block, determined in accordance with paragraphs 49 to 54 inclusive;
- (b)  $i$  is a funds management institution or a dual licensed entity's funds management activities other than the management of the total balances of RSEs; and
- (c) *Other reg requirements* are any non-APRA regulatory or financial capital requirements that apply to a funds management institution. If more than one non-APRA regulatory or financial requirement is applicable to the same funds management institution, the greater requirement (in dollar terms) must be used. No adjustments, for ITEs or otherwise, must be made to the non-APRA regulatory or financial capital requirements.

#### *Required capital – OA block*

40. Required capital for the OA block is determined as follows:

$$RC_{OA\ block} = \max \left( ICA_{OA}, \sum_i Other\ reg\ requirements_i \right)$$

where:

- (a)  $ICA_{OA}$  is the Level 3 group's internal capital allocation for the activities conducted in the OA block, determined in accordance with paragraphs 49 to 54 inclusive;
- (b)  $i$  is a Level 3 institution located in the OA block or the non-funds management activities of a dual licensed entity or funds management institution; and
- (c) *Other reg requirements* are any non-APRA regulatory or financial capital requirements that apply to a Level 3 institution located in the OA block. If more than one non-APRA regulatory or financial requirement is applicable to the same Level 3 institution, the greater requirement (in dollar terms) must be used. No adjustments, for ITEs or otherwise, must be made to the non-APRA regulatory or financial capital requirements.

#### **Adjustments for intra-group transactions and exposures**

41. Where a Level 3 institution has ITEs to other institutions in the Level 3 group against which capital is required to be held at **Level 1** (including, where applicable, by overseas equivalent institutions in the ADI, GI and LI blocks on a standalone basis) or **Level 2**, subject to paragraphs 42 to 48 inclusive these ITEs

must be eliminated at Level 3 and the applicable capital requirement reversed in the calculation of the required capital for the relevant industry block(s). Adjustments must be undertaken within each relevant industry block. When adjusting for ITEs, both sides of the transaction must be taken into account in recalculating risk charges for each industry block. Adjusting for ITEs may affect required capital for both on- and off-balance sheet exposures.

42. The following categories of ITEs must not be excluded from the determination of industry blocks' required capital figures in accordance with paragraph 41:
- (a) market risk hedges<sup>8</sup> between Level 3 institutions in a Level 3 group;
  - (b) ITEs that are subject to an insurance risk charge or insurance concentration risk charge determined under:
    - (i) *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge* or *Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge* for general insurance Level 2 groups, or, where there is no general insurance Level 2 group, for Level 1 general insurers and any equivalent risk charge for equivalent overseas general insurers; or
    - (ii) *Prudential Standard LPS 115 Capital Adequacy: Insurance Risk Charge* for statutory funds of life companies and approved benefit funds and the management fund of friendly societies, and any equivalent risk charge for equivalent overseas life companies;
  - (c) the investment of shareholder funds by a Level 3 institution with another institution in a Level 3 group where the latter institution is engaged in funds management activities. 'Shareholder funds' are funds invested on behalf of institutions in the Level 3 group where the group itself derives all gains and losses related to such exposures and investments. The Level 3 institution with which the shareholder funds are invested adjusts its capital requirement in accordance with paragraphs 43 to 45 inclusive; and
  - (d) where a Level 3 institution that is not operationally separated or separable (as set out in paragraph 53) has an ITE with a Level 3 institution that is operationally separated or separable, this ITE must not be reversed.<sup>9</sup>

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<sup>8</sup> A market risk hedge is an investment risk exposure by a Level 3 institution that is hedged with another institution in the Level 3 group so that the latter institution effectively bears the risk. In such a case, the latter institution must include the investment risk borne in the determination of its required capital. The former institution will not be required to include the investment risk borne as it is already included for the purposes of determining the Level 3 PCR. Where such market risk hedges lead to (counterparty) credit risk charges against Level 3 institutions in the Level 3 group, these must still be eliminated.

<sup>9</sup> Paragraph 45 describes the treatment of ITEs in relation to funds management activities involving institutions in the FM block that are subject to the approach set out in paragraph 53.

*Intra-group funds management activities (external funds)*

43. For the purposes of calculating Level 3 required capital for funds management activities, the requirement will be applied only to external funds. External funds are funds relating to funds management activities from outside the Level 3 group that flow into the group. Where funds relating to funds management activities move between (pass through) Level 3 institutions in the Level 3 group, these funds do not qualify as external funds.
44. The capital requirement on all subsequent pass through of funds within the Level 3 group – whether within a Level 3 institution engaged in funds management activities, between different Level 3 institutions engaged in funds management activities in the same industry block, or between Level 3 institutions engaged in funds management activities in different industry blocks – must be adjusted in the determination of the required capital for the Level 3 institutions receiving the funds.<sup>10</sup> For institutions in the ADI and LI blocks receiving pass through funds, only the operational risk charge<sup>11</sup> must be adjusted to exclude pass through funds.
45. Where a Level 3 institution in the FM block is operationally separated or separable (as set out in paragraph 53) and reduces its internal capital allocation to account for this, any of its external funds that are ultimately passed through to a Level 3 institution in the Level 3 group that is not operationally separated or separable must instead be included in the latter institution's required capital calculation.

*Securitisation SPVs*

46. A **securitisation SPV** must be assessed against the requirements in *Prudential Standard APS 120 Securitisation*, Attachment B, taking into account all **securitisation exposures** to the securitisation SPV from all Level 3 institutions in the Level 3 group, in particular regarding significant risk transfer, to assess whether the securitisation SPV meets the operational requirements for regulatory capital relief from a Level 3 perspective.
47. For the purposes of calculating the Level 3 prescribed capital amount:
  - (a) a securitisation SPV that meets the operational requirements for regulatory capital relief from a Level 3 perspective may be treated as being external to the Level 3 group. Level 3 institutions in the group with an exposure to the securitisation SPV must include such exposures in the determination of required capital of the relevant industry blocks. Where the Level 3 Head chooses not to apply this treatment, it must apply the treatment set out in paragraph 47(b); and

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<sup>10</sup> For the purposes of this paragraph, shareholder funds (refer to paragraph 42(c)) are not external funds and are therefore considered pass through funds.

<sup>11</sup> As determined in accordance with: *Prudential Standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk*; *Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk*; *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge*; or similar requirements by host jurisdictions in case of equivalent overseas deposit-taking institutions or life companies.

- (b) a securitisation SPV that does not meet the operational requirements for regulatory capital relief from a Level 3 perspective must be consolidated into the originating Level 3 institution in the Level 3 group and receive a capital charge based on the required capital calculation for the industry block in which the originating institution is located. Any other institutions in the group with exposures to the securitisation SPV must treat these exposures as ITEs and adjust them in accordance with the method set out in paragraphs 41 to 45 inclusive.

#### *Significant effort to accurately determine ITEs*

- 48. Where significant effort would be required to accurately determine a specific ITE adjustment, a Level 3 Head may, subject to APRA's written agreement:
  - (a) use a conservative approximation for the impact on the Level 3 PCR of the ITE adjustment; or
  - (b) choose not to take the adjustment into account, where adjusting for the ITE would lead to a net reduction in the Level 3 PCR.

#### **Internal capital allocation**

- 49. It is the responsibility of the Board of a Level 3 Head to ensure the internal capital allocations for the FM and OA blocks adequately reflect the risks associated with the activities being conducted within these industry blocks.
- 50. The Board of a Level 3 Head must ensure that the Level 3 group develops and maintains a process for determining the internal capital allocations for the FM and OA blocks. This process must ensure that the internal capital allocations:
  - (a) reflect all material risks to APRA beneficiaries that arise from the activities undertaken by Level 3 institutions in the relevant industry block. Intra-group risks that are eliminated on consolidation must not be taken into account:
    - (i) the Level 3 group must apply the process set out in paragraphs 43 to 45 inclusive to determine the external funds that are subject to an internal capital allocation in the FM block; and
    - (ii) the Level 3 group must apply a process similar to the one set out in paragraphs 41 and 42 to identify intra-group risks in relation to the OA block;
  - (b) do not incorporate expected future profits and future management actions;
  - (c) are based on a rigorous and robust methodology;
  - (d) reflect the risk appetite, as stated in the Level 3 group's ICAAP, of the Board of the Level 3 Head; and



- (e) have regard to the impact of institutions in the FM and OA blocks on the ability of the Level 3 group's APRA-regulated institutions to meet their obligations to APRA beneficiaries, including through contagion risks.
51. An internal capital allocation must be a positive amount and must not include diversification benefits in respect of risks relating to activities undertaken by Level 3 institutions in the Level 3 group that are not located in the industry block for which the internal capital allocation is determined.
  52. A Level 3 group must document the rationale, design and operational details of its internal capital allocations. The group must have documented policies and procedures for the regular review of the internal capital allocation processes and outcomes.

#### *Operational separation and operational separability*

53. A Level 3 group may demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries referred to in paragraph 50(e) through the operational separation or operational separability of the Level 3 institution(s) in the FM or OA block from which the risk emanates. APRA will determine in writing to the Level 3 Head whether it agrees that the group has credibly reduced the risk to APRA beneficiaries. The considerations APRA will take into account when performing this assessment include, but are not limited to, whether:
  - (a) the relevant institutions in the FM or OA block are separated from APRA-regulated institutions through a Level 3 NOHC structure;
  - (b) exposures from non-separated Level 3 institutions to the relevant institutions in the FM or OA block are subject to more stringent limits through the group's ITE policy than other ITEs (refer to *Prudential Standard 3PS 222 Intra-group Transactions and Exposures (3PS 222)*);
  - (c) the relevant institutions in the FM or OA block have Boards and senior management that are effectively independent from APRA-regulated institutions;
  - (d) the relevant institutions have group badging and product distribution arrangements clearly separate from APRA-regulated institutions; and
  - (e) the group has a recovery plan that demonstrates that the group can readily dispose of the relevant institutions should it face financial distress.
54. Paragraph 53 is not applicable to a Level 3 group that contains a systemically important ADI as determined by APRA.

#### **Capital shortfall assessment**

55. A Level 3 group may hold Level 3 EC to cover its non-APRA-regulated institutions<sup>12</sup> contribution to the Level 3 PCR anywhere in the Level 3 group.

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<sup>12</sup> Any reference to non-APRA-regulated institutions in a Level 3 group in paragraphs 55 to 58 inclusive also refers to the group's Level 3 NOHC, where applicable.

However, where a non-APRA-regulated institution in the Level 3 group has insufficient Level 3 EC to cover its contribution to the Level 3 PCR, the Level 3 Head must ensure that the group has sufficient capital available in the group to cover this shortfall.

56. As part of its ICAAP, a Level 3 Head must, on a regular basis:
- (a) identify non-APRA-regulated institutions in the Level 3 group that have insufficient Level 3 EC<sup>13</sup> to cover their contribution to the Level 3 PCR; and
  - (b) based on the requirements set out in paragraphs 57 and 58, determine whether other Level 3 institutions in the Level 3 group have sufficient unrestricted surplus capital to cover the shortfall identified in paragraph 56(a).

This assessment must be performed on a legal entity basis unless otherwise agreed with APRA.

57. Capital relating to, or needed to cover, the following items is restricted and not available to cover the capital shortfall:
- (a) planned reductions in the Level 3 group's Level 3 EC in accordance with the requirements in paragraph 62;
  - (b) prudential requirements on APRA-regulated institutions<sup>14</sup> (e.g. PCRs and ORFR target amounts) and requirements imposed on Level 3 institutions by regulators other than APRA<sup>15</sup>;
  - (c) for ADIs in the Level 3 group, the ADI capital conservation and countercyclical buffers as determined in accordance with APS 110;
  - (d) the lowest capital trigger above the regulatory minimum set in accordance with a Level 1 or Level 2 ICAAP as required by APRA, or a similar process as required by any other regulator;
  - (e) capital that, once moved to the recipient institution, would result in a breach of exposure limits determined in accordance with 3PS 222;
  - (f) for ADIs in the Level 3 group, capital that, once moved to the recipient institution, would result in a breach of exposure limits determined in

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<sup>13</sup> For the purposes of the capital shortfall assessment, a Level 3 institution's 'Level 3 EC' must be determined in accordance with 3PS 111 but on a legal entity basis rather than a consolidated basis. Equity holdings and capital support provided to other institutions in the Level 3 group must be deducted from the Level 3 institution's Level 3 EC as this capital will be included in the Level 3 EC figure of the institutions receiving the capital.

<sup>14</sup> In the case of APRA-regulated institutions forming part of an ADI Level 2 group or general insurance Level 2 group this item refers to both the Level 1 requirement and the Level 2 requirement.

<sup>15</sup> This includes regulatory or financial requirements imposed by non-prudential regulators such as market conduct regulators.

accordance with *Prudential Standard APS 222 Associations with Related Entities*;

- (g) capital that, once moved to the recipient institution, would result in a breach of exposure limits set in accordance with a Level 1 or Level 2 ICAAP;
- (h) any prudential limits on equity holdings in and/or capital contributions to non-APRA-regulated institutions;
- (i) restrictions imposed by regulators other than APRA;
- (j) capital needed by Level 3 institutions to meet their obligations as and when they fall due;
- (k) minority interests included in Level 3 EC as defined in 3PS 111;
- (l) any legal restrictions on transfers between institutions such as exchange or currency controls, shareholder rights, **policyholder** rights or general contractual obligations;
- (m) any other items that the Level 3 Head considers relevant; and
- (n) any items that APRA, by notice in writing, determines not to be transferable.

For the purpose of this assessment, any additional costs that the Level 3 group has to bear as a result of transferring capital, such as taxation (e.g. income, capital gains or withholding tax) or currency exchange costs, must be deducted from the amount ultimately available to absorb losses.

- 58. In addition to the items listed in paragraph 57, capital is considered to be restricted if it cannot be transferred from a Level 3 institution to the relevant non-APRA-regulated institution in the Level 3 group within five business days from the decision to move capital being made.
- 59. The requirement for an APRA-regulated institution to seek APRA's written approval or consent prior to making a planned reduction in capital under APS 110, GPS 110 or LPS 110 is not a restriction on capital for the purposes of the assessment described in paragraphs 56 to 58 inclusive.
- 60. APRA-regulated institutions in a Level 3 group that are subject to an ICAAP target amount at Level 1 or Level 2 may hold the part of this target amount that meets the criteria set out in paragraphs 57 and 58 in an APRA-regulated institution of which it is a subsidiary, subject to APRA approval. The Level 3 Head must satisfy APRA that the capital is expressly held for that subsidiary only; it may not be utilised for other purposes.

## Disclosure

- 61. A Level 3 group must not disclose any Level 3 supervisory adjustment included in the Level 3 PCR as set out in paragraph 25, nor any Level 1 or Level 2

supervisory adjustments applicable to APRA-regulated institutions in the group that are included in the determination of required capital for the industry blocks.

### Reductions in capital

62. A Level 3 Head must obtain APRA's written approval prior to any Level 3 institution in the Level 3 group making any planned reduction in capital that would result in a reduction in Level 3 EC.
63. A planned reduction in Level 3 EC includes:
  - (a) a share buyback or the redemption, repurchase or repayment of any qualifying Level 3 EC instruments issued by Level 3 institutions in the Level 3 group;
  - (b) trading in own shares or capital instruments of the Level 3 Head outside of any arrangement agreed with APRA in accordance with 3PS 111; and
  - (c) the aggregate amount of dividend payments on ordinary shares of the Level 3 Head to **third parties** that exceeds the Level 3 group's after-tax earnings after taking into account any payments on more senior capital instruments, in the financial year<sup>16</sup> to which they relate.
64. A Level 3 Head proposing a capital reduction must provide APRA with a forecast showing the Level 3 group's projected future capital position (including Level 3 PCR) after the proposed capital reductions. The forecast should extend for at least two years.
65. A Level 3 Head must satisfy APRA that the Level 3 group's Level 3 EC will remain adequate for the group's future needs after a proposed reduction and that the group retains sufficient unrestricted surplus capital to cover the shortfall in non-APRA-regulated institutions in the Level 3 group and, where applicable, its Level 3 NOHC.

### Supporting information

66. A Level 3 Head must provide APRA, on its request, with supporting information on any aspect of the Level 3 group's capital adequacy.

### Notification requirements

67. A Level 3 Head must inform APRA as soon as practicable of:
  - (a) any breach or prospective breach of the Level 3 group's Level 3 PCR;
  - (b) any significant departure from the Level 3 group's ICAAP;

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<sup>16</sup> 'Financial year' means a period of 12 consecutive months covered by one or more sets of publicly available operating results preceding the date of the proposed payment of dividend or interest. For example, where a Level 3 group makes available half-yearly operating results, a financial year will refer to the preceding two publicly available half-yearly operating results for the Level 3 group.

- (c) any breach of the requirement that the Level 3 group must have sufficient unrestricted surplus capital to cover the capital shortfall in non-APRA-regulated institutions in the group and, where applicable, its Level 3 NOHC;
- (d) any indication of significant adverse changes in market pricing of, or trading in, the capital instruments of Level 3 institutions in the Level 3 group (including pressures on the group to purchase capital instruments issued by institutions in the group); or
- (e) any other significant adverse changes in Level 3 EC or the Level 3 prescribed capital amount.

The notice must include any remedial actions taken or planned to be taken to address the situation, and the timing of these actions.

### **Adjustments and exclusions**

68. APRA may, by notice in writing to a Level 3 Head, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to the Level 3 Head.<sup>17</sup>

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<sup>17</sup> Refer to subsection 11AF(2) of the Banking Act, subsection 32(3D) of the Insurance Act and subsection 230A(4) of the Life Insurance Act.

**Attachment A****Level 3 Head activities**

1. A Level 3 NOHC may undertake the following activities:
  - (a) hold investments in subsidiaries;
  - (b) raise funds to invest in, or to provide support to, subsidiaries;
  - (c) hold properties used by other Level 3 institutions in the Level 3 group;
  - (d) raise funds to conduct its own limited activities;
  - (e) invest funds (all capital held within the NOHC other than investments in other Level 3 institutions in the Level 3 group) on behalf of the Level 3 group;
  - (f) provide executive leadership across the group; and
  - (g) any activities that must be undertaken by a Level 3 Head to meet its obligations under APRA's Prudential Standards.
2. A Level 3 NOHC must seek APRA's written agreement prior to undertaking activities that relate to undertaking a 'corporate centre' role, such as group treasury activities, risk management, reinsurance management, settlements, information technology, human resources, financial reporting and other group services such as company secretarial services.
3. A Level 3 NOHC must not undertake any activities other than those outlined in paragraph 1 of this Attachment and those outlined in paragraph 2 of this Attachment for which it has received APRA's written agreement.